Commentary
Cash

October 2021

Monthly Cash Review

State Street EUR Liquidity LVNAV Fund

Although the European Central Bank kept policy rates unchanged and indicated no intention of near-term rate hikes, financial markets were pricing in an increased probability of a modest rise in rates within a year against the backdrop of robust economic data and persistent inflationary pressures. While longer-dated bond yields moved higher once again, short-term market rates remained largely stable through the month.

Policy

The Governing Council of the European Central Bank (ECB) met on 28 October, when it kept its policy settings and forward guidance unchanged; the deposit rate thus remains at -0.50%, the main refinancing rate at 0%, and the marginal lending rate at 0.25%. The Pandemic Emergency Purchase Program (PEPP) remains at €1.850 trillion, with the ECB confirming that this will end in March 2022, but it did not elaborate on the future of its Asset Purchase Program (APP). The Bank confirmed that it will make monthly asset purchases under the PEPP at a "moderately lower" pace compared to March-September and that it will continue net purchases under the APP until shortly before it starts to raise key ECB interest rates.

At the press conference following the meeting, ECB President Christine Lagarde said that the council has spent a lot of time "soul searching" about inflation, but having done so, had concluded that the rise in inflation data was transient. She went on to highlight the three main factors driving inflation higher; energy prices — especially oil, gas and electricity — have risen sharply; the imbalance between supply and demand, related to the economies reopening; base effects relating to the end of the VAT cut in Germany. The ECB expects these to ease over 2022 or fall out of the calculations.

Outlook

Headline inflation remains elevated, energy prices have increased, and staff shortages and supply chain bottlenecks remain issues, all fuelling inflation fears. ECB President Lagarde explained that "it is not for me to say if markets are ahead of themselves". Unfortunately, the ECB talk has had a limited impact on market expectations. At the end of October, the futures markets were pricing in a 55% probability that the overnight rate will be around sixteen basis points (bps) higher by September next year (compared to last month, when only a 4% probability was priced in that the rate would be only 1bp higher). The next council meeting is on 16 December. The ECB has communicated that the December meeting will be the timeframe for further policy updates.

Data

The eurozone economy demonstrated greater strength in the third quarter, with GDP expanding 2.2% quarter-on-quarter (q/q), to leave it only 0.5% below its pre-pandemic level. On a year-on-year (y/y) basis, GDP expanded by 3.7% in Q3, following a downwardly revised 14.2% rate in the previous period. Amongst the major economies: Italy grew 2.6% q/q; Germany grew 1.8% q/q; France's growth was 3.0% q/q; Spain was weaker, growing by 2.0 q/q with the Spanish tourism sector still struggling to recover. The ECB's latest GDP growth projection for 2021 is 5%. For 2022 and 2023, the ECB expects eurozone GDP growth to come in at 4.6% and 2.1%, respectively.

The eurozone's flash headline inflation rate continued to trend higher from 3.4% in September to 4.1% in October. This was stronger than anticipated and represents its highest reading since July 2008. Market expectations are for eurozone inflation to move higher as input and energy costs continue to feed through. Recent oil and gas prices have pushed the energy inflation rate up to 23.5%. Core inflation (which excludes energy, food, alcohol and tobacco) rose to 2.1% in October, up from 1.9% in September, to stand at its highest level since December 2002. The ECB's current projections for HICP inflation stand at 2.2% in 2021, 1.7% in 2022, and 1.5% in 2023.

The ECB's latest unemployment projections are for 8.2% in 2021, 7.9% in 2022, and 7.4% in 2023. Amongst the largest euro area economies, the highest jobless rates were recorded in Spain (14.6% in Q3), Italy (9.3% in August) and France (8% in Q2), while the lowest rates were in the Netherlands (3.1% September) and Germany (3.4% September).

The eurozone composite purchasing managers' index (PMI) dropped sharply from 56.2 in September to 54.3 in October, the lowest reading in six months. The main concern that the PMIs highlight is that price pressures continue to work their way to consumers as shortages in the economy are starting to bite. Eurozone industrial production declined by 1.6% in August, following a revised 1.4% m/m growth rate in July. The country breakdown shows that production (excluding construction) fell the most in Germany by 4.1% m/m, and the Netherlands where it fell by 3.1% m/m. However, it increased by 1.0% in France and was roughly flat in Italy and Spain. Vehicle production was down 17.2%, largely impacted by Germany, although other countries are seeing the impact of component shortages. However, economic sentiment in the region improved for the second month in a row, from a reading of 117.8 in September to 118.6 in October, painting a more positive picture. The strong sentiment figures showed a boom in services sectors' confidence with both expectations and recent demand improving. Manufacturing order books improved, but production expectations are falling.

Germany's recovery continues to lose momentum. German industrial production reported a massive 4% m/m fall in August, leaving industrial output 9% below its pre-pandemic February 2020 level. Manufacturing output fell 4.7%, largely due to a 17.5% fall in vehicles and vehicle components, with prospects for Q4 deteriorating. The Ifo Business Climate Index recorded its fourth successive monthly decline to 97.7 in October from 98.8 in September. Weakness was not confined to the manufacturing sector, as retail sharply declined, and services edged lower. There are concerns that the rising number of cases of Covid is beginning to affect consumer confidence.

Markets

The ECB has been more cautious about removing support than their US and UK counterparts and is looking to keep the stimulus going for a lot longer because of the fragility of Europe's economy. Initially we saw a flattening of the euro government bond yield curves, with yields moving lower at the longer end. However, following President Lagarde's comments that the phase of higher inflation will last longer than initially expected and her refusal to say "if the markets are ahead of themselves", we saw euro government yields move wider; German 10-year Bund yields rose by 9 basis points (bps) in October, closing at -0.11% (from -0.20% in September); Italian 10-year government yields followed suit, rising 31 bps to close at 1.17% (from 0.86% in September). The spread between 10-year Italy and Germany bond yields widened, ranging between 105–130 bps over the month.

Green issuance has been a major theme for primary markets. There was further issuance in October, with the European Union becoming the largest green issuer in the world as it looks to use green assets to finance almost a third of its €800 billion recovery plan (with the EU flagging €250 billion of green bond issuance between now and the end of 2026.). The first EU green bond was €12 billion in size, with reported demand of €135 billion.

Excess liquidity deposited with the ECB continued to increase, averaging €4.413 trillion in the month, with a high at €4.432 trillion on 8 October. This has increased by over a trillion euros since January! The euro short-term rate (€STR) was stable through October, averaging a yield of -0.57%. Euro money market curves were higher from one year and further out, with inflation concerns remaining high. However, fixings in the shorter curve remained stable; one-month Euribor averaged -0.56%; three-month Euribor averaged -0.55%, hitting an all-time low -0.557% on 28 October; six-month Euribor averaged -0.53% and one-year Euribor averaged -0.48%, with the one-year 1 bp higher compared to September.

Euro cash overnight deposit rates ranged between -0.57% and -0.65%. Government repo ranged from -0.60% to -0.62%. Euro-denominated core government bill yields ranged from -0.66% to -0.88%. Three-month French Treasury bills averaged -0.74% in October. As we approached month-end, we saw increased activity in euro bills, supposedly driven by a shortage of collateral in the repo markets with prices rising in response and yields moving lower.

Fund

At the fund level, the weighted average maturity (WAM) averaged 39 days in October. We selectively targeted high-quality credit issuers in the one-to-three-month duration range, with selective investments past six months. Asset-backed paper continued to be in good supply, offering flexible duration and attractive returns compared to vanilla paper. As always, liquidity and capital preservation remained the key drivers for the portfolio, with yield a distant third.

Source: State Street Global Advisors/Bloomberg, 31 October 2021.
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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of September 30, 2021 and includes approximately $59.84 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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